

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0257
SALES AND USE TAX
FOR TAX PERIODS: 1994-1996

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1. Sales and Use Tax: Bad Debt Deductions

Authority: IC 6-2.5-6-9, 26 U.S.C.A. Sec. 166, 26 C.F.R. Sec. 1.166-1 (c).

Taxpayer protests the adjustments made for bad debts.

2. Tax Administration: Penalty

Authority: IC 6-8.1-10-2.1, 45 IAC 2.2-3-16.

Taxpayer protests the imposition of penalty.

Statement of Facts

Taxpayer is a clothing retailer. After an audit, Taxpayer was assessed additional sales and use tax, interest and penalty for the tax period 1994-1996. Taxpayer protested the assessment and a hearing was held. More facts will be provided as necessary.

1. Sales and Use Tax: Bad Debt Deductions

Discussion

During the tax period, Taxpayer had an agreement with a related factoring company and bank to administer Taxpayer's proprietary credit card program. Taxpayer's customers used credit cards issued in Taxpayer's name to finance purchases at Taxpayer's retail stores. Pursuant to the agreements, Taxpayer sold to the factoring companies the credit

slips for the amounts shown thereon less a discount equal to the bad debt percentage incurred in the previous year and the rights to collect on the debts. At the end of each fiscal year the payments were "trued up," i.e., Taxpayer and the factoring company determined the actual amount of bad debt losses arising from credit card transactions during the year and adjusted the payments accordingly. The agreement expressly made Taxpayer responsible for all bad debts with respect to transactions under the agreement. At this point, Taxpayer does not retain recourse against the customers. Taxpayer wrote the bad debts off on their federal adjusted gross income tax returns and claimed the bad debt deduction on their sales tax returns. The bad debt deduction was disallowed in the audit report.

The sales tax law provides for a bad debt deduction at IC 6-2.5-6-9 as follows:

In determining the amount of state gross retail and use taxes which he must remit. . . , a retail merchant shall deduct from his gross retail income from retail transactions made during a particular reporting period, an amount equal to his receivables which:

- (1) Resulted from retail transaction in which the retail merchant did not collect the state gross retail or use tax from the purchaser;
- (2) Resulted from retail transaction on which the retail merchant has previously paid the state gross retail or use tax liability to the department; and
- (3) Were written off as an uncollectible debt for federal tax purposes during the particular reporting period.

In this instance, Taxpayer clearly meets the first two requirements. It paid the sales tax to Indiana but did not ever collect it from the purchaser. The issue to be determined is whether Taxpayer meets the third requirement for the deduction of bad debts.

26 U.S.C.A. Sec. 166 allows for the deduction of a bona fide debt from adjusted gross income tax. The term "bona fide debt" is explained at 26 C.F.R. Sec. 1.166-1 (c) as a debt which is "a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money."

In this case, Taxpayer sells the account receivables to another entity. Customers actually owe the debt to the bank. Pursuant to the submitted agreements, the bank has the right to collect the debt from the purchasers of Taxpayer's product. Taxpayer does not have that right. Therefore, Taxpayer has no recourse against the customers who do not fulfill their obligations to satisfy their credit card liabilities. Pursuant to the terms of the federal law and regulations, the bona fide debt is between the customer and the bank. Taxpayer does not have a bona fide debt and cannot write off bad debts for adjusted gross income tax purposes. Taxpayer does not meet the third requirement to deduct bad debts for sales tax purposes.

Finding

Taxpayer's protest is denied.

2. Tax Administration: Penalty

Discussion

Taxpayer's final point of protest concerns the imposition of the ten per cent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

Taxpayer had a duty to maintain adequate records to substantiate its computation of the sales and use tax due to the state of Indiana and provide those records at the Auditor's request. Taxpayer's breach of this duty constitutes negligence.

Finding

Taxpayer's protest is denied.

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